RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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Aug. 7, 1991 **LETTER 1075**

July 26 DJIA 2972.49; PTI 3330; A-D Ratio -11.56
Aug. 2 DJIA 3006.26; PTI 3350; A-D Ratio -11.09
Dow Yield: 3.07%; Dow P/E: 22.8; DowPow: 5
Dow 200-day MA: 2787; Dow 30-day MA: 2966
Dow Book Value: 1331; PTI 89-day MA: 3286
Percentage of Undervalued Blue-chips: 13%
Summation Index: 1533

THE PICTURE: For five frustrating months the stock market has not been able to decide whether to break out of its trading range. The Dow has been fluctuating (stuck) in a 6% trading range ever since last February. Within this seemingly dull and boring trading range a fierce struggle has been going on. The struggle is obviously between the bulls and the bears. The buyers (bulls) are convinced that the worst is over and that stocks are a buy for increasing earnings in 1992 and beyond. The bears (they're the ones who are giving the bulls the stocks) are convinced that all the "recession is over" talk is wishful thinking, and that the economy will get worse before it gets much better.

What do the bulls have going for them? The last Dow Theory signal was a bull signal. The Leading Economic Indicators would seem to suggest that the recession is over. Stocks made a big move between October 1990 and March 1991, and so far the market seems to be digesting that move fairly well. Individual stocks may fall apart on bad news, but the major stock averages have been holding well. A few of the foreign markets have hit new highs. In the US, the market technicals such as advances and declines, highs and lows, most actives, etc., appear to be all right with most even providing mildly bullish readings.The Summation Index has turned bullish. According to Joe Granville (nobody else calculates this statistic), 503 common stocks on the NYSE are now within one point of their 52-week highs. Despite raging deficits the bond market has been acting well. And last but not least, the Fed has been moving to lower interest rates (well, short-term rates, anyway).

The bears retort, "If things are so bullish, why is it so blasted hard to make money in this market?" The bears note that the money supply statistics are poor, and no recession has ever ended with literally no growth in the money supply. The bears note that most extended trading ranges that materialize near the top of advances tend to be areas of distribution, and they argue that the current one will be no different. But the major bear argument is that stocks are extremely overvalued and that the risk/reward for those betting on the upside is poor. There simply isn't enough room on the upside to make any money (even assuming that the averages finally break out of their trading range). The bears remind us that at 3100, the Dow will be yielding less than 3%.

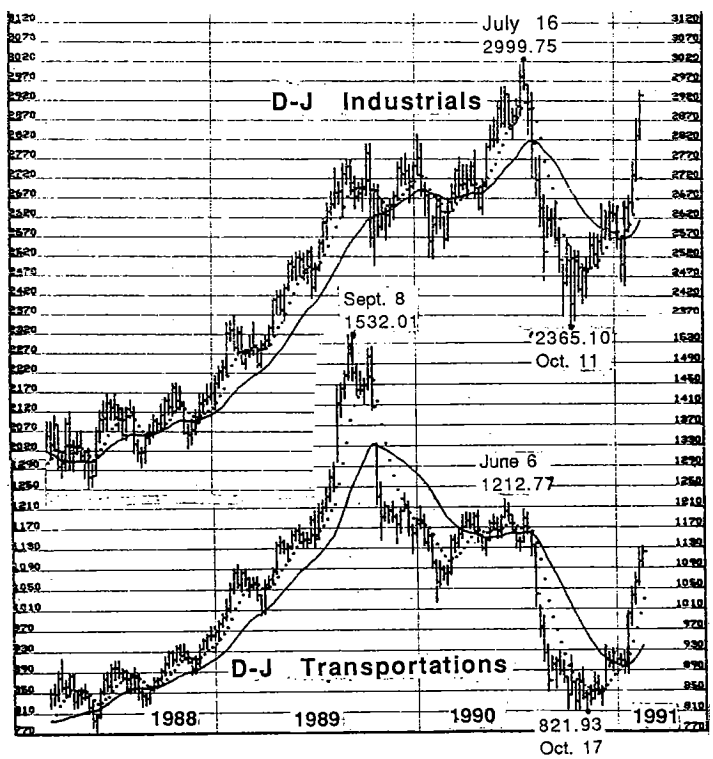
But are stocks really as overvalued as the bears claim? The charts on page 2 would seem to provide the answer. The price-to-book value of the S&P 400 Industrials is pictured on Chart 1. Any way you look at, on a price-to-book basis stocks are sky-high. Chart 2 shows the S&P 500 on a price-to-earnings basis. Here too, it is seen that stocks are expensive. Chart 3 shows stocks on a price-to-dividend ratio. The dividends on the S&P 400 are now $12.47. The P/Div. ratio is therefore 37, very high by historical standards. Finally, Chart 4 shows the percentage of stocks over or undervalued. Currently, about 40% of the stocks are overvalued. That corresponds to the area of tops, as seen on this chart, going all the way back to 1950 [these four charts courtesy of *Ned Davis Research* -- (800) 241-0621].

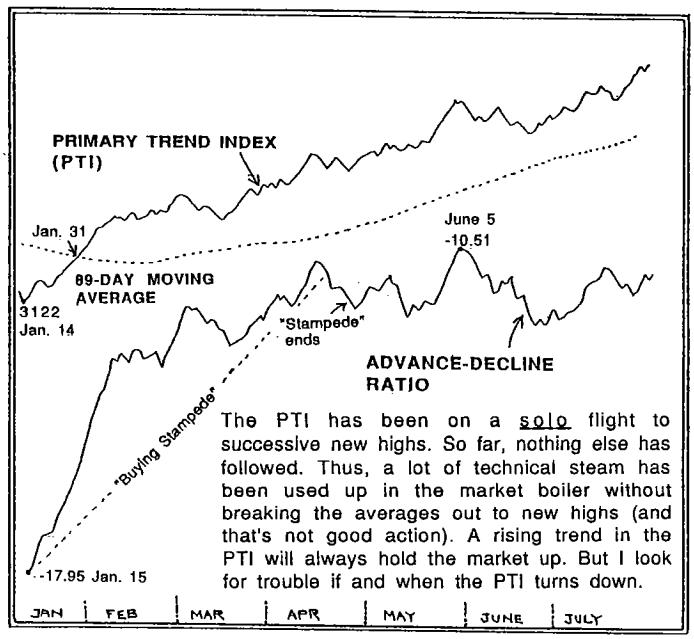
So the bears' argument is that based on that most fundamental of all considerations, values, stocks are a sale rather than a buy. And the upside, if indeed there is one, is very limited and not worth the gamble.

Which arguments do I subscribe to? On the big picture (not the short term), I am just super-cautious. True, the last Dow Theory signal was a bull signal, and you must keep that in mind. But in my opinion, the risk/reward equation for the bulls is too thin here, so thin that I don't think it's worth assuming a major position in stocks in this area (a trading position, perhaps, but not a major position).

Primary Trend Index (PTI): My PTI, as noted in the last Letter, has been advancing to record highs. This means that the technical understructure of the market remains bullish. In other words, for whatever reason, the pressure on the market is to the upside (of course, the PTI doesn't ask for or need reasons). If the PTI continues in its bullish trend, the result can be likened to steam pressure building up in the boiler. At some point the market and the averages will respond -- with higher prices.

NEW HIGHS? If the Dow breaks out to new highs, it will be important to watch for confirmations from some of the other major indicators. Here are a few of the averages that I will be watching together with their significant highs -- D-J Transportation peak (recorded June 4): 1251.76; D-J Utility Average peak (rec. June 4): 220.89; S&P 500 Composite peak (rec. April 17): 390.45; NYSE Composite peak (rec. April 17): 213.21; Value Line Composite peak: 246.89. A new high by the Dow alone, unconfirmed by any of the other averages, could present problems. So watch the picture carefully.





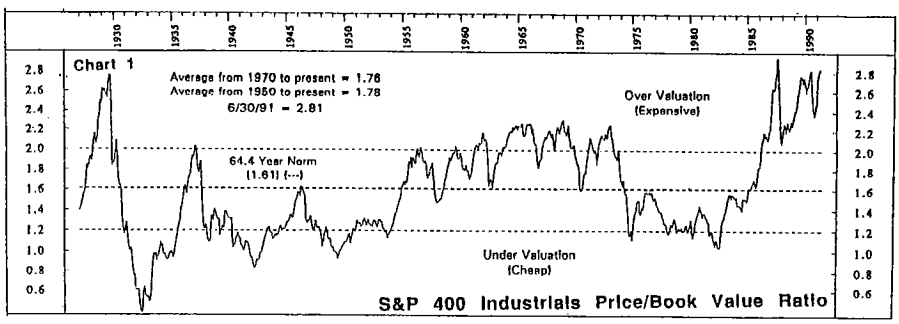
The PTI has been on a solo flight to successive new highs. So far, nothing else has followed. Thus, a lot of technical steam has been used up in the market boiler without breaking the averages out to new highs (and that's not good action). A rising trend in the PTI will always hold the market up. But I look for trouble if and when the PTI turns down.

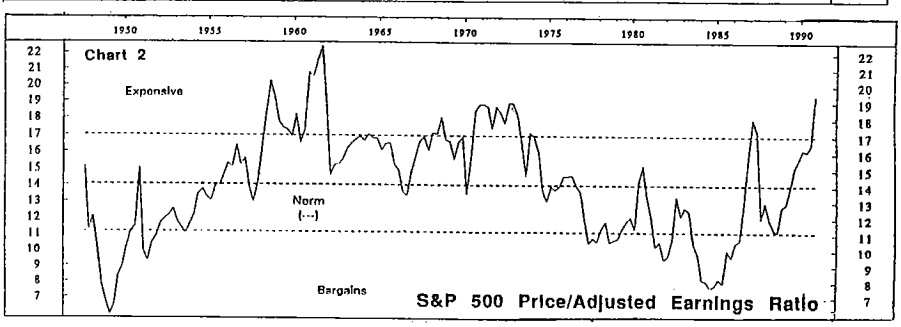
THE ECONOMY: My opinion? The US remains in recession, a recession that has been punctuated by a mild respite or "breather". Economists have accepted the respite as meaning that the recession is over. I think they're going to be wrong.

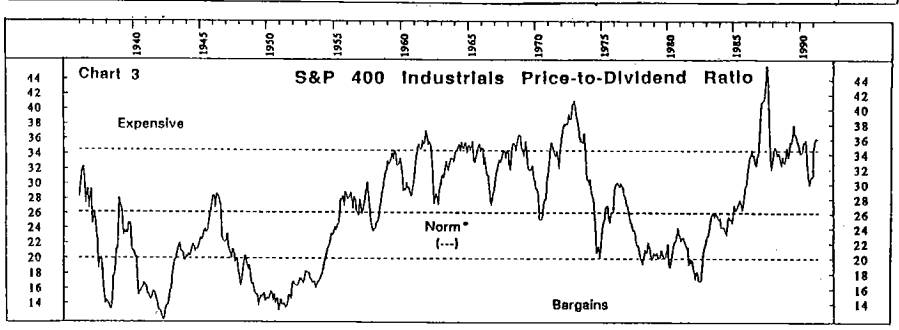
First the economists said "no recession". Then they told us (almost to a man) that it was going to be a mild recession, a recession that would end before 1991 was over. Currently, the economists tell us that the recession is over, and that we're on the way up. Time will tell.

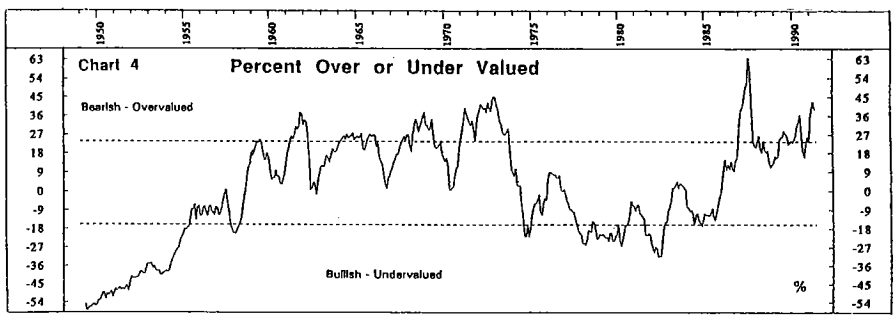
How have the markets taken it? So far, the stock and bond markets have accepted all bad news simply as news that would pressure the Fed to lower interest rates. And aren't lower rates literally guaranteed to end the recession? So the market has held up or even rallied on bad news, and investors continue to feel confident that the recession is now over, and better times lie just around the corner (we old timers probably remember the Depression song, "Just around the corner, there's a rainbow in the sky, so let's have another cup of coffee, and let's have another piece of pie.").

Personally, I look for a continuing recession, continuing denials out of Washington, continuing credit distress, a continuing squeeze on the profits of many corporations, continuing huge government deficits, and high or rising unemployment.









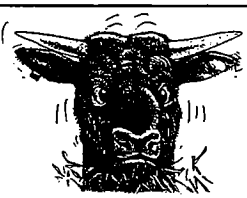
I also look for increasing pressure on the Fed to take the discount rate down another notch in an effort to boost the money supply. This perception is already (1) exerting mildly bullish pressure on bonds, (2) putting a top on the dollar, and (3) putting a bottom on most of the commodities. But whether the dollar goes into a major bear market and whether commodities go into a major bull market from here remains to be seen. Bonds, although they are subject to temporary bullish pressure, also have to deal with (a) re-inflation pressures ahead, (b) continuing massive government borrowing, and (c) competition from higher foreign rates. Therefore, I would expect any further rise in bonds to be labored and subdued (Note: total government borrowing next year could approach the half-trillion dollar mark).

Each week I study the charts of the 30 Dow stocks, and this exercise often (but not always) helps me to get a feel for the market. How many of the 30 stocks look bullish at this point? Here's what I see in the bull camp. After behaving poorly during 1990, Allied Signal has recently (and suddenly) spurted up almost to its 1989 high. American Telephone acted poorly until late last year, but during 1991 the stock has come back and is now acting slightly better than the market. The same goes for Beth Steel, which turned up in relative strength (RS) in the second quarter of '91. Coca Cola has been a hot item for years and is currently near new highs in RS and price. DuPont did nothing until late '90, but since then it's been acting bullishly, recently making the new high list. JP Morgan, the only AAA rated of the big city banks, turned up in the third quarter of 1990, has looked good ever since. Gen. Electric has been an excellent performer since the last quarter of '90, but the stock looks to be fading now. Goodyear turned up and started spurting in the final quarter of '90. Stock looks OK, but currently overbought. International Paper has been a good actor ever since mid-'90, and it looks all right now. Merck has been one of the star performers of recent years and is currently near its highs in both price and relative strength. Philip Morris has been a winner all along, but since the first quarter of '91 the stock has leveled off. Doesn't look too promising from here on.

That's about it for the Dow stocks that look good at this point. Now how about the rotten actors? American Express has been a dog for a long time, and is showing nothing at this point. Boeing reached a peak in price and RS in the third quarter of 1990. The stock has now broken below its longer-term moving average (MA). The same goes for Caterpillar, which I would avoid. Kodak has been losing RS for a couple of years. The stock shows nothing and should be avoided. IBM has been a stinker, and even now it is bouncing around a multi-year low -- avoid. Westinghouse has been a very poor actor. RS turned down during the second quarter of 1990, and the stock is now flirting with a multi-year low -- leave it alone.

That's it. The stocks not discussed are mostly in indistinct trends or doing nothing of note. The hope of the Dow lies basically with the bullish stocks discussed above.

INVESTMENT POSITION: Ferdinand, the quivering bull, is still in the box. This market is so sneaky and deceptive the bull can hardly bear it. Bruin, the patient bear, (he's still in hiding) can hardly bull-leave what's happening -- so he waits.



Too few investment advisors talk about risk/reward. Yes, it's possible to make a stupid profit, and it's also possible to take an intelligent loss. A Las Vegas gambler may take home a wad of money on any given day, but to me that's a stupid profit. It's stupid because mathematics and the odds tell us that over any extended period of time gamblers lose and the house wins.

Does the same thesis apply when you buy stocks in an overvalued area? Probably. With the Dow currently in the 3000 area and selling at 22 times earnings with dividends at 3.1%, you have history against you when you buy stocks in this area. Sure, the Dow could rally 100 or even a few hundred points from here, but it's a risky proposition. Buying stocks here for a potential 100-200 point rally (when you figure taxes and the sweat involved) just isn't that brilliant a move.

In the last Letter I stated that I took a moderate position in a no-load growth fund. Was I a genius? Hardly. I did it simply on the basis of a climbing PTI plus what looked like a sold-out Summation Index. I also did it because the market has been in a five-month trading range, and an awful lot of rotten news hasn't been able to knock it down.

I continue to like two-and three-year Treasury paper in this area. The new three-year notes just went for a yield of slightly above 7%. A safe 7% isn't a bad place to park your money at this time. And if the market is in the tank by late fall, you can tell your friends you saw it all coming, and they'll undoubtedly call you a bloody genius.

RUMINATIONS: Twenty years ago I didn't think I'd live to say this, but I'll say it now: I don't think my kids will live as well as I've lived, and I'm talking about economics and their standard of living.

As far as I'm concerned, our Washington politicians have sold my kids and future generations down the river. It's a shame, it's disgusting. Really it's almost criminal. But there's an old adage that states that people always get the government they deserve. I believe it. We've voted in these political hacks time after time. We did it. We refused to throw them out of Washington, and now we're suffering for it, and our kids will suffer even more for it. Furthermore, we let our presidents get away with economic murder. Neither Reagan nor Bush have ever presented a balanced budget. Both of them talked balanced budget, but when the chips were down they acted like vote-getting politicians, and the deficits continued to explode. And they never took a hard stand. Hell, they never even told the truth about the deficits. Fact: When Reagan took office the total federal debt was $1 trillion. By the end of 1992 it will be $4 trillion. That amounts to deficits of $250 billion a year for 12 straight years.

The government is now paying over $200 billion a year in interest on the federal debt. Pretty soon the annual interest on the debt will climb over $300 billion, and next we'll be paying a billion dollars a day in interest. The fact is that we're eating ourselves up alive, and nobody in Washington is taking a hard stand.

How will it be resolved? How will it end? Nobody knows, because nobody knows when the crisis will hit or exactly how it will hit. As I see it, the rising debt will either lead to crushing deflation and ultimate government "re-negotiating" of the debt, which means extending it out to the future or maybe only paying interest on the debt while refusing to redeem the principal.

Or the situation could lead to wild inflation, as the government pumps up the money supply in its effort to finance and refinance all the hundreds of billions of bills and notes and bonds coming due.

Or the situation could lead to a collapse in the dollar as foreigners refuse to accept any more dollar-denominated debt. A dollar collapse could lead to more inflation, as the dollar price of foreign goods surges higher. But on the other hand a dollar collapse would scare the devil out of foreign holders of US securities. If foreigners panicked and dumped those securities for whatever they could get for them, interest rates could explode upward, leading to deflation and recession or worse.

As taxes rise and as deficits continue to build in all areas of the US economy, one effect it is having is that it is squeezing out the middle class. The rich are surviving, because they have their capital working for them. The poor are surviving because the government is subsidizing them. But it's the middle class, which is being squeezed unmercifully today, and it's the middle class that is finding it increasingly difficult to make ends meet.

I wish I could see events turning out differently, but I don't. I wish I had the magic means of changing the trend, but I don't. I've run out of answers.

Are there any bright spots in my scenario? Yes. Today I think we are further from a major war than at any time since World War II. The cold war is over, and the Soviets seem to be on the verge of (or at least thinking about) moving to free markets. As the father of a 13 year old boy, this means a lot to me. Second, there have been staggering advances in the field of medicine and in the health sciences. Having lived in the period prior to antibiotics, that means a lot to me. From a health standpoint, the quality of life today is infinitely better than it was when I was a boy.

But finally, from a stress standpoint (and this does impact on our health), I think life is more stressful today than it was 25 or 50 years ago. Business is more complex, government intervention is more odious, taxes are higher, there is more red tape, there are more law suits. And the incidence of crime is far higher. Almost everyone now has to think in terms of surviving today's crime wave. To walk the streets of any big city today (and particularly at night) is an exercise in survival.

My own solution to all the problems (marital, business, government): learn to communicate and insist on telling the truth. If everyone would communicate and if everyone insisted on the truth in politics, in their business dealings, in their marriages, in every aspect of their life, the world's problems would be resolved. I absolutely believe that. Examine ANY problem, and behind that problem you'll find that the parties failed to communicate and refused to tell the absolute truth.

But insisting that everyone tell the truth, that's a tall order. My own view of humanity -- "People live on the lies they tell themselves and the lies they tell others." When that changes, the world will change. Jesus said it almost two thousand years ago, "The truth will make you free."

NOTES & QUOTES: Saddam Hussein continues to thumb his nose at the US and its allies as he plays, "Now you see it, now you don't, and if you see it, where is it?" It's conceded that Iraq has four times the chemical weapons facilities that the UN "experts" thought it had. What's next? Will Bush make a deal with Gorbachev, and will there be joint bombing of Iraq? Was that why Gorby got "Most-Favored-Nation" status from Bush? Will Saddam continue to turn Desert Storm into Desert Failure? Stay tuned.

* *

Mitsubishi Motors and Honda Motors have announced (in a major breakthrough) that they are producing new engines that will get as much as 20% more mileage for the same performance. Some of Honda's fall models will carry the new engine, which will take the Civics 87 miles a gallon at 40 MPH. Detroit has no such engines, nor do they have plans to develop them. Said one auto analyst, "As usual, the American industry has been fighting the regulations rather than making much progress in improving the technology to meet the regulations."

Only one motor company the world over is red hot -- no it's not Toyota or Honda -- it's Harley Davidson (stock is at a record high). Harley motorcycles are not only "most wanted" in the US, they're coveted in Europe and Asia. If you want to know how a motor company is doing, don't ask the analysts, ask the dealers. Ask any Harley dealer, and they'll tell you that they can't deliver (and you heard that here months ago).

* *

In a shocking July 30 *WSJ* piece, ex-Treasury official Paul Craig Roberts accuses the Bush men of "cooking the books" on the federal deficit. Craig states that "no greater fraud has even been perpetrated on the American people." Strong words, but note how the truth comes only from officials who have left office.

Roberts states, "As the story went, President Bush purchased $500 billion in deficit reduction by signing on to a $165 billion tax increase . . . Nine months later the OMB has released its mid-session review of the budget. Far from a five-year deficit reduction of $500 billion, the cumulative deficit forecast for 1991-95 has doubled to $1.087 trillion." Roberts writes that "before the budget agreement was reached, the government knew that its claims for deficit reduction would not be achieved. It withheld revised economic assumptions that showed that the recession would eat up the projected revenues from the tax increase, together with the 20% of the claimed outlay reductions . . . However, instead of facing outrage for blatant fraud, Mr. Bush was widely congratulated for his 'realism' in rejecting the myth that economic growth could reduce the deficit. The fraudulent deficit-reduction bandwagon rolled on, growing in outrageousness."

Roberts warns, "Moreover, the growth in federal deficits may be far from over. States and localities are generally prohibited by law from consistently running deficits, and so to pare their deficits, they are likely to increase income and property taxes, which are federally deductible. Thus, as these taxes rise, federal tax revenues grow less rapidly with income -- which itself grows less rapidly as taxes rise . . . As the true magnitude of the budget fraud begins to come to light, those responsible are beginning to run to cover. Mr. Daman blamed the revenue shortfall on a mathematical goof by Treasury revenue estimators. Such public fingerpointing by one administration department on another suggest that more shoes are due to fall."

Russell opinion: Fraud is the only word for it. The disgraceful, ballooning, out-of-control federal deficits will ultimately lead either to depression or hyper-inflation. Right now I feel the economy and the markets are in "no-man's land" midway between the forces of depression and hyper-inflation (if the government hadn't stepped in to support the banks and the S&Ls there is no question in my mind but that this nation would now be in a depression).

* *

The German inflation rate has risen to 4.5%. That kind of inflation in Germany is a red flag -- it's like 10% inflation to Americans. Helmut Schlesinger, the new head of the Bundesbank, is well known as a fierce inflation fighter, and the talk is of a rise of perhaps 1% in the German bank rate after August 15 when the bank's executives next meet. Meanwhile, the Fed might lower the US discount rate in an effort to get the money supply moving up. If German rates go up and US rates go down, the dollar should take it on the chin. But the administration probably wants a lower dollar -- anything to spur exports.

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From our "Here's What's Happening Dept": (Part of a letter received last week from a subscriber) -- "Dear Mr. Russell, Just received your latest newsletter and read with interest your comments about California (from which we have just moved) and your suggestion of the American Northwest (our new home) as the 'coming area.' We could not agree more. After a feature article in the Travel section of the *LA Times* sparked our initial interest two years ago, my wife and I made four trips to Coeur d' Alene, Idaho, to be as sure as possible about such a big step. We have no regrets. Sold our typical 20-year old S. California tract house (1,590 sq. ft.) for $246,000 (paid $172,000) four years ago. Bought a brand new, 1,730 sq. ft. home in the nicest family neighborhood in town for $120,000 (a lot of money in these parts -- the median price home here is $83K). Property taxes on this home in Idaho are $960. Registered our vehicle (my wife's Lexus was $83 vs. $770 in Calif.) . . . The town is home to what *Conde Nast Travel* magazine has called the 'Best Mainland Resort'. The resort, indeed the town itself, is situated on a large lake; reminding many Californians of Lake Tahoe in size and beauty without the gambling and the cheesiness" (there was more). Russell comment: Well, you get the idea. Governor Wilson and the airheads in Sacramento, are you listening -- and do you give a damn? And will you get my vote in the next election?

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What Money Will Buy: Did you know that the new Immigration Act of 1990 (which takes effect this October) sets aside 10,000 permanent residency visas "for foreigners who invest substantial capital in a new commercial enterprise" in the US. Substantial capital is defined as $500,000 for "targeted unemployment areas." In addition, the enterprise must create at least 10 new jobs for US workers. Of the 650,000 permanent residency visas issued each year, 520,000 are for people who are close relatives of US citizens. But if you have no close relatives, bring money and start a business.

* *

Russian Jews are pouring into Israel at a massive rate. By 1995 they'll comprise 20% of Israel's entire population (one million Russian Jews will be added to the Israeli population). But there are problems. A large percentage of the new Jews are professionals. Israel is now swimming in thousands of new doctors, engineers, scientists. And many can't find jobs. Furthermore, almost all of the new Russian Jews have lost contact with their religious roots. A recent poll found that only 3% of the Russian Jews call themselves "religious." In Russia few Jews live together in communities and restrictions were placed on Jewish community life -- so the Soviets have produced a nation of "non-Jewish" Jews.

* *

I read 12 newspapers a day and I don't know how many magazines a week. People sometimes ask me, "Russell, if you could read only one magazine what would you read? For general news and a world view I immediately suggest the *Economist*. Then they ask, "If you could read only one newspaper, what would you read?" I unhesitatingly tell them -- the *New York Times*. There's nothing like the *Times* for a national and world view, and over recent years the *Times* has become much more human (or interesting) because they've put some spice into their writing style, and I don't even think anyone call the *Times* "the Old Grey Lady" anymore.

Another paper which I like very much is owned jointly by the *Washington Post* and the *NY Times*, and it's the *International Herald Tribune*. This excellent paper has the advantage of some of the best articles from both the NY Times and the Washington Post plus many articles from their own writers. The paper is very international, and I wouldn't be without it. I have recommended it a few times before, and a few months ago I got a call from their market manager. He said that they had received many subscriptions from my subscribers, and he wanted to know what I had said. I told him that what I said was that I like his paper. I also told him that I had been sending *Dow Theory Letters* to their Paris financial

editor for years, so how about returning the favor and giving me a gratis subscription to the *Tribune*. By gad, he said OK, so now I'm on the freebie list. I continue to recommend the *International Herald Tribune* -- in the US call (800) 882-2884.

* *

Have you noticed that your favorite magazine is looking mighty thin? The reason: since the 1987 market crash, advertising has dropped off precipitously (this is the case with TV, newspapers and magazines). Even magazines aimed at the rich have lost advertising, and this hasn't happened in previous recessions. Look at these figures: advertising is down 29.7% for *Metropolitan Home, Town & Country* down 36.8%, *Architectural Digest* down 29.8%, *Elle* off 22.5%, *Harper's Bazaar* down 19.6%, *Forbes* down 18.7%, *Financial World* down 35.9%, and on and on.

* *

Could it be happening? According to the *International Herald Tribune*, "A high Soviet government official (Deputy Prime Minister Scherbakov) said that his government plans to switch 400 military factories to full-time civilian production, and this was part of a broader conversion program that could eventually affect as much as 80% of its defense plants." It is estimated that (incredibly) as much as 52% of Soviet factories are engaged in producing military products of one kind or another. And the switch to production of civilian goods will be very difficult to say the least. Said Gorbachev at the G-7 meeting, "We are ready to open up our holy of holies," meaning the military industry.

* *

Blacks make up 12% of the US population, but only 6% of the baseball attendance is black, and that worries baseball owners. The fact is that blacks are moving their affections from baseball to basketball and football. The percentage of black players in major league baseball has fallen from 23% in the '60s to 18% today. In contrast, today 74% of pro basketball players are black and 62% of the NFL is black. One problem: colleges give few scholarships to baseball players. If you're a black high school football or basketball star, you can literally pick your college and get a scholarship to boot.

* *

The massive cutbacks in the banking business continue. Citicorp has fired 7,000 with 10,000 slated to go. NCNB has said "good bye" to 9,000, Chemical/Hanover has fired 6,200, Chase Manhattan 5,000, Security Pacific 2,000, and on and on. The same thing is happening in the computer and software fields and in many other fields. It's a rush to stay solvent, and one of the biggest expenses is personnel. And then there's the government. They might start with the Post Office, which employs 880,000 people. But I forgot -- the federal government and its agencies only get bigger.

* *

The Bank of Credit & Commerce International (BCCI) is shaping up as "the mother of all scandals," one of the biggest and most astounding fraud cases in world history with losses heading into the $10 to $15 billion class. The bank is totally offshore, based in no one country. The story is so complicated and perplexing that few magazines or newspapers have really tackled it, and the TV networks have hardly touched it. *Time* magazine has been on it, however, and their July 29 cover article is a beaut. The story is still emerging, but it includes chicanery in 70 countries, the CIA, the Defense Dept., massive bribes to top politicians and leaders, and cover ups in all areas. It also concerns the "black network," of at least 1500 people who did the BCCI's dirty work. The dirty work includes arms deals, bribery, espionage, extortion, drug trafficking and maybe even murder. As far as the depositors who put billions of dollars into the bank, it is thought that most of that money is gone. The news of this "criminal bank" is just beginning to emerge. Expect shocker after shocker from the BCCI story. The questions here are whether US agencies put clamps on the story, and whether any regulators or government officials were bribed.

* *

Can This Country Survive Dept.? California's dizzy Jerry ("Moonbeam") Brown reports that he might consider running for the presidency. And New York's ("he's in, he's out, he may, he may not") Governor Cuomo also might run. So it looks like George ("Let's do a parade") Bush may have an easy time of it -- unless, of course, Adrian Van Eck and Elliot Janeway and Harry Schultz are correct, and the nation sinks into depression first.

* *

Gambling in LA is reviving in a big way via the booming population of Asiatics. The game that's doing it is Pai Gow, a complicated Oriental game played with domino-like pieces. Says the Bicycle Club's manager, "Nobody realized the potential of the Asian market. It is now the lifeblood of our business." Last year the club grossed $87 million against $37 million six years ago. Says Mike Caro, an expert on gambling and author of five books on the subject, "The amount of money being bet by these Orientals is mind-boggling. Some of the biggest money games anywhere are now in LA card rooms. I believe this is the highest-limit action in the world on a sustained, day-after-day basis." At one high-stake club, the estimate is that $600,000 an hour is being wagered on the Pai Gow tables.

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In a July 27 *NY Times* piece, economist Alfred Kahn notes that over the last 40 years the percentage of our GNP income devoted to consumption "has increased steadily and frighteningly" from 58.5% in the '50s to 64.6% in the '80s. During the same period the percentage of GNP we've used to increase our assets has remained the same while net business investment in plant and equipment has dropped 20%. Kahn continues, "A society that is unwilling to live within its means and that devotes a steadily decreasing portion of its income to saving and investment in physical plants, technology and people, will inevitably be restrained once the flow of credit from the outside begins drying up. The restraint may come from an increase in the price it has to pay for its imports or by recession or depression or both. That is exactly what has happened. We are now paying the price, in unemployment and in more and more families needing two wage earners to make ends meet. No wonder the *Economist* magazine summarized the trends in our real income over the last 15 years as 'Running to Stand Still'."

Along these same lines, it is now clear that there is a shortage of world capital. The big capital suppliers during the 1980s were Japan, Germany and the US. Japan's stock market is now down 40% from the highs, and major Japanese companies are now trying to reliquify. Germany needs all the capital it can get and more -- to rebuild East Germany. The US, which borrowed and spent it's head off during the '80s, is trying to get out from under, but with a low-growth money supply and ongoing massive budget deficits. If the international credit crunch doesn't end soon, the best we will see ahead is world economic stagnation.

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DEFLATION/INFLATION: I've mentioned Adrian Van Eck in recent Letters. Mr. Van Eck edits and publishes the *Money-Forecast Letter*, 7 October Hill Rd., Holliston, Mass. 01746. Adrian, as I've stated before, has an excellent record of being right about the economy and the markets. Van Eck's message today is an ominous one. Here are a few quotes from his recent report:

"As we see it, much of the good work that Volcker did is being slowly and systematically destroyed. By starving America for money, the Fed's Open Market Committee is setting us up for not only a Depression, but for a subsequent explosion of inflation as America takes the only route open to escape from the Depression. We mean a massive expansion of the Money Supply and inflation worse that we have seen in many years. Wall Street and Washington are both living in the pink haze of a dream world . . . and the dream is about to turn into a nightmare."

Van Eck then compares the current situation with 1982 . "In 1982 Banks were straining at the leash to loan Money out, once the Fed pumped money into their waiting hands. Today the Banks are refusing to lend money out. When the Fed does allow Reserves to build up in the Banks, the Bankers most often use that Money to buy SUPER-SAFE TREASURY DEBT. THE TREASURY HAS BECOME A GIANT SIPHON, DRAINING MONEY OUT OF THE BANKS AT SUCH A RATE THAT THERE REALLY IS ALMOST NOTHING LEFT FOR BUSINESS OR CONSUMERS TO BORROW."

In other words, Van Eck is of the opinion that the Fed (consciously or probably unconsciously) is creating the money-background for a

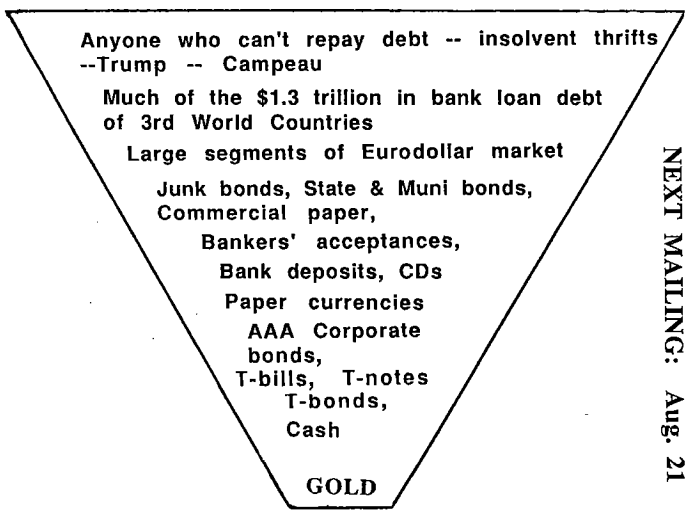
depression. Then once the depression become reality, he believes that the Fed will attempt a massive creation of money in order to counter-act the collapsing economy. The Fed's efforts (if they are successful) will lead to super-inflation (see Exter comments in the Gold section).

Russell opinion: I tend to agree with Adrian Van Eck. But what worries me even more is that if this nation does sink into a deflationary depression, the debts (all debts including the federal debts) will loom as Frankenstein monsters, almost impossible to service. A collapse in tax receipts (due to plunging corporate profits and rising unemployment) will send city, state and federal deficits off into space.

A plunge in the economy would drop almost all but AAA rated bonds into the cellar, thereby pushing most bond yields through the roof. With profits falling and bond yields sky-high, stocks would lapse into a bear market tail-spin. This then, is the scenario that I think could materialize.

Added comments: I think the action of gold and the bonds are particularly interesting here. Let's say, for the sake of argument, that the above scenario is the correct one. If so, then gold, like everything else, would be subject to the forces of deflation. And right now, as I write this, I believe that deflationary forces are currently weighing heavily on gold (and even more heavily on silver, which is not a monetary metal).

GOLD: This is the "debt pyramid" as presented by my old friend, John Exter (former Vice President, Federal Reserve). John has been a gold-proponent going back as far as I can remember (which is pretty far). John has been watching the growth of America's giant debt mountain. John believes that the result of the huge debt build-up will be a great deflationary collapse, followed by a massive inflation. He believes we are seeing the beginning of the deflationary collapse now.


Anyone who can't repay debt -- insolvent thrifts --Trump -- Campeau
Much of the $1.3 trillion in bank loan debt of 3rd World Countries
Large segments of Eurodollar market
Junk bonds, State & Muni bonds, Commercial paper,
Bankers' acceptances,
Bank deposits, CDs
Paper currencies
AAA Corporate bonds,
T-bills, T-notes
T-bonds,
Cash
GOLD

As John perceives it, there will be "a deflationary collapse rather than an inflationary blow-off because creditors in the debt pyramid will move down the pyramid out of the most illiquid debt at the top of the pyramid -- junk bonds, failing banks, S&Ls and insurance companies, Donald Trump, Campeau. Creditors will try to get out of these weak debts and go down the debt pyramid to the very bottom, currency (dollar bills), even though they pay no interest."

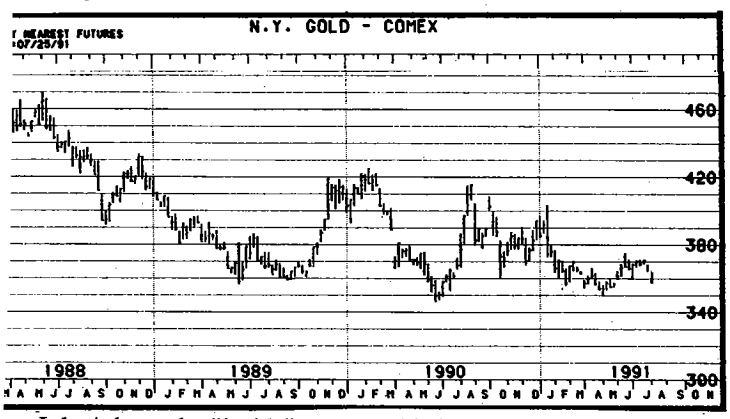
John notes that there is already a huge demand for cash. "The final step down is out of the debt pyramid and into gold." He adds that "just as the debt pyramid sits on a tiny golden point that supports a huge superstructure, that door of escape is very narrow. There isn't much room for many people to squeeze through."

All right, that's the rationale for owning gold. If the debt pyramid self-destructs through deflation and bankruptcy, the only way out of the system is via gold -- gold, the only true money and the only money which is not someone else's liability.

But, back to the the world of non-theory, back to the world of the markets. Gold's actual performance has been frustrating for gold-philes. It's been discouraging for conservative monetary theorists. And for unemotional market practitioners, gold's performance can only be labeled as rotten.

However, as I've said so many times before, we don't hold gold for great profits, anymore than we hold our life insurance policies for the big pay-off. We hold gold because it's outside the system, and there are plenty of signs that the system is bankrupting itself. When gold finally heads skyward, it won't be a boon to gold holders. It will be a tragedy because exploding gold prices will reflect either all-out inflation or a crumbling financial system with people rushing to buy that bottom level in the pyramid [Debt pyramid and Exter quotes courtesy of *The Moneychanger* -- (901) 373-3626].

This weekly chart of gold (courtesy of *CRB Futures Chart Service*) puts the gold picture into perspective. Here we see the series of declining tops in gold with a base in the 345-350 area. So far, it's almost as if large interests have been playing the gold market, buying whenever gold gets down around 350 and selling whenever gold gets around or over 385.



I don't have the "inside" story as this is written, but on August 2 some nation or some central bank dumped gold, knocking the metal down seven dollars to well below 360. Was it the Soviets? Was it the Arabs? We don't know, and I'm not sure it matters.

One thought: Let's theorize that the US (and perhaps the rest of the world) is going into a deflationary slump. IF that happens, the first reaction of gold could be DOWN -- the "normal" reaction to deflation. If the US is truly deflating, I would expect the worst and most ominous casualty to be the nation's real estate. If real estate goes down, the banks, S&Ls and insurance companies would suffer massive bankruptcies. Anything with debt against it would be falling apart. Such chaos would turn the financial system on its head, and the rush would be on for safety and almost surely ultimate safety, which would mean being out of the system and into gold.

Let me put it another way -- gold's first reaction to deflation would be down, but as the financial situation in the US continued to deteriorate the second reaction would be to get out of almost everything else and into the safety of the only item with no debt against it -- gold.

LATE NOTES: (1) The broad M-3 money supply is declining at a record rate of minus 2.9% (year-to-year basis). This is putting increasing pressure on the Fed to lower rates again (and lower rates make for a WEAK dollar). (2) Furthermore, the US has never before climbed out of recession with negative money growth. . . . (3) The latest figure for the Gross Federal debt is $3.576 trillion. Exactly one year ago it was $3.168 trillion. Thus, the addition to the federal debt over the last 12 months was a **record $408 billion! . .** (4) Deflation of the money supply and rising debt, it adds up to the big squeeze. (5) Up to now it would seem that the stock market couldn't care less about the declining money supply. The institutions don't care either -- they're cash levels are down to a record (miniscule) 5%. Yep, everyone's loaded with stocks -- so let the party begin (I closed out my trading position in no-load funds for a small profit).

NEXT MAILING: Aug. 21